

**BEFORE THE POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001**

Annual Compliance Report, 2012

Docket No. ACR2012

COMMENTS OF PITNEY BOWES INC.

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I. INTRODUCTION

Pitney Bowes Inc. (Pitney Bowes) respectfully submits these comments on the Annual Compliance Report for Fiscal Year 2012, filed by the Postal Service on December 28, 2012 (FY2012 ACR). These comments address: (1) the disparity in the cost coverage and unit contribution of First-Class Mail Single-Piece and Presort Letters / Cards, (2) cost modeling changes necessary in Automation First-Class Mail Presort Letters, (3) cost modeling changes necessary in First-Class Mail Flats, and (4) recommendations for future proceedings to improve transparency and accountability under the Commission's rate regulations.

II. DISCUSSION

A. **ACR2012 data confirm that the Postal Service is not leveraging its pricing flexibility to reward its more profitable products and maximize its contribution**

The FY2012 ACR confirms that First-Class Mail Presort Letters / Cards continue to be much more profitable than Single-Piece First-Class Mail Letters / Cards. In FY 2012, the unit contribution for First-Class Mail Presort Letters / Cards is 23.3 cents, more than five cents greater than the 18.1 cent unit contribution of Single-Piece First-Class Mail Letters / Cards. *See* FY2012 ACR at 8. This disparity in unit contribution persisted within the First-Class Mail Letters rate design since the Postal Service began reporting costs and revenues by product in the FY2008 ACR. The FY2012 ACR data also confirm a disparity in cost coverage between Presort Letters / Cards and Single-Piece Letters / Cards. For FY2012 the cost coverage for Presort Letters / Cards is 292 percent, nearly twice that of Single-Piece Letters / Cards (166 percent).

Perpetuating these disparities in unit contribution and cost coverage harms the Postal Service financially. Under the CPI price cap, the amount of revenue that the Postal Service can collect is constrained, but how the Postal Service collects this revenue matters. Because there

are differences in unit contributions from different products, not all revenue is equal. A more equitable rebalancing of the cost coverage and unit contributions among First-Class Mail products (which would lower Presort Letters / Cards prices) would substantially increase the total contribution from First-Class Mail to the financial benefit of the Postal Service. *See* PRC Dkt. No. ACR2011, DMA Comments (Feb. 3, 2012) at 3-4; PRC Dkt. No. RM2009-2, DMA Comments (Sept. 11, 2009) at 5-6. This is especially true because Presort Letters / Cards are much more price sensitive than Single-Piece Letters / Cards. *See* Econometric Demand Equation Tables for Market Dominant Products as of January, 2013 (Filed January 22, 2013) at 2, 5. Because every piece of presort mail that it can generate or keep in the system makes, on average, an extra five cents, the Postal Service must do everything it can to preserve and encourage the growth of Presort Letters.

In the past the Postal Service has argued that the Commission's workshare rules have contributed to the growing disparities in cost coverage and unit contribution. But the Postal Service must also bear some responsibility. The Postal Service has not used its pricing flexibility to constrain price increases on its most profitable products as it should have. The cumulative increase for first ounce Single-Piece Letters over the past three pricing adjustments was 4.5 percent. The CPI increase over the same period was 6.9 percent. The cumulative price increase for first ounce 5-Digit Automation Letters over the same period was 7.5 percent. *See* R2013-1 PB Comments at 2. Larger price increases and larger mark ups on Presort Letters undercut the Postal Service's efforts to slow the erosion of its most profitable product in First-Class Mail.

The Postal Service does not offer any justification for imposing a disproportionate burden on its most efficient and price sensitive First-Class Mail products. One possibility is that the Postal Service is pricing in response to volume trends as it has in Standard Mail. Another

possibility is that the Postal Service is pricing to bring the work in-house in response to short-term excess capacity. *See infra* at 7-9. Both of these approaches should be rejected.

In attempting to justify the proposed price adjustments for Standard Mail Flats in Docket No. R2013-1, the Postal Service presented a contribution model (USPS-LR-R2013-1/7) purporting to demonstrate that applying above-average increases to products with declining volumes would hurt its profitability. The Commission correctly concluded in that proceeding that the Postal Service's contribution model was theoretically unsound. *See* PRC Order No. 1541 at 39-43. The Postal Service has filed two new models as part of the FY2012 ACR. The new models are similarly flawed and the results are assumption-driven.¹ Use of more accurate assumptions flips the results, showing that smaller price increases on the higher-contribution products – offset by larger increases on lower-contribution products – improves Postal Service finances.²

For example, the retrospective model uses a price elasticity of -0.2 for Standard Mail Letters, *see* USPS-LR-43, *ScenarioAnalysisforStandardMailContribution.pdf* at 6, despite the fact that the Postal Service's most recent demand equation for the former Standard Regular subclass (which consisted primarily of Standard Mail Letters) is -0.437. *See* Econometric Demand Equation Tables for Market Dominant Products as of January, 2013 (Filed January 22, 2013) at 8. Increasing the price elasticity assumption for Standard Mail Letters to -.437³ results

¹ *See, e.g.*, USPS-LR-43, *StdRetrospective.xls*, "Other Inputs," where the model states "Assumptions are necessary because the price elasticity of demand is not known for Flats and Letters separately. The user should feel free to vary the assumptions."

² The prospective model assumes based on recent volume trends that Standard Mail Flats volumes will drop 40 percent over an eight-year period while Standard Mail non-Flat volumes will grow over the same period. *See* USPS-LR-43, *StdProspectivev1a*, "Assumptions." As the PRC explained in Order No. 1541, "The Alternative Contribution Models' assumption that a recent volume trend will continue 8 years into the future is overly simplistic and belied by a review of the prior 8-year period, which reveals the effect of then-existing economic and related factors on postal volumes." PRC Order No. 1541 at 43.

³ The Postal Service cannot argue that the own-price elasticity is lower than for the Standard Regular subclass. A recently-filed USPS document summarizing changes in demand equations stated, "Separate equations for letters and

in a finding that larger increases for Standard Mail Flats (the low-contribution product) offset by smaller increases for Standard Mail Letters (the high-contribution product) would have *increased* FY 2009 to FY 2012 USPS contribution by \$120 million. *See* USPS-LR-43, StdRetrospective, “Contribution Summary” after setting Standard Mail Letters own-price elasticity to -0.437 in “Other Inputs.” This is despite substantial Standard Mail Flats volume declines from FY 2009 to FY 2012.

In light of the financial challenges currently facing the Postal Service, it is essential that it rebalance the unit contribution among products in First-Class Mail and Standard Mail. Pricing to preserve and encourage the growth of more profitable First-Class Mail Presort Letters and Standard Mail Letters will create a more equitable price schedule and will improve the Postal Service’s financial position.

B. Cost Modeling Changes are Necessary to Accurately Measure Workshare-Related Costs Avoided within First-Class Mail Presort Letters

Worksharing increases productive efficiency by incentivizing mailers and mail service providers to perform upstream activities if their costs are lower than the Postal Service’s. When private parties bypass Postal Service operations, the total combined costs for the postal system decreases, and the savings to society are substantial. Increases in productive efficiency through worksharing have historically resulted in innovation and increased mail volumes. Pricing geared to lowest combined costs is necessary today to stimulate innovation and to help stem the erosion of profitable mail volumes.

For these reasons the Postal Service should provide workshare discounts that maximize productive efficiency and lower the total combined costs of the postal system by passing through

non-letters were also investigated for Standard Mail (by subclass), but were not deemed to be sufficiently reliable to be adopted at this time.” Changes to Econometric Demand Equations for Market Dominant Products since January, 2012 (filed January 22, 2013) at 1.

the full measure of workshare-related costs avoided. Unfortunately, as shown in Table 1 below, using FY2012 ACR data none of the workshare discounts within First-Class Mail Automation Letters fully reflect the cost the Postal Service avoids because of work performed by mailers. All of the passthroughs are less than 100 percent.

Table 1. First-Class Mail Automation Letter Passthrough Calculations

| Presort Level | Discount | Cost Avoidance | Passthrough |
|----------------------|-----------------|-----------------------|--------------------|
| AADC | 2.1 cents | 2.6 cents | 81 percent |
| 3-Digit | 0.0 cents | 0.6 cents | 0 percent |
| 5-Digit | 2.4 cents | 2.5 cents | 96 percent |

The failure to passthrough the full measure of workshare-related costs avoided in the discounts is inefficient, reduces social welfare, and results in excessive prices for the Postal Service’s most profitable and most efficient product – Presort Letters. Compounding the problem, the passthroughs presented in the table, which are uniformly too small, are likely overstated. As explained below, the actual passthroughs would be *even smaller* if the Commission adopted needed improvements to the First-Class Mail workshare cost avoidance models.

A case in point is Docket No. RM2012-6, where the Commission is considering a change in analytic principle with respect to the measurement of workshare-related costs avoided within First-Class Mail Presort Letters. If adopted, the change proposed in that docket would result in an increase to the AADC cost avoidance from 2.6 cents to 2.9 cents and an increase in the 5-Digit Automation Letter cost avoidance from 2.5 cents to 2.8 cents. If this change were made,

the passthroughs reported for AADC and 5-Digit Automation Letters would be 72 percent and 83 percent, respectively.⁴

Pitney Bowes agrees with the Commission that (“[a]s the Postal Service’s operations and pricing incentives change, it may be necessary to modify the approach used to evaluate the affected discounts.” *See* Dkt. ACD2011, Annual Compliance Determination Report (Mar. 28, 2012) at 99). Indeed, the Commission’s rules and its compliance obligations require a dynamic process. But two annual compliance reports have been filed and reviewed since the Postal Service eliminated a separate price for 3-Digit Letters. This should not be permitted to continue. A new benchmark for purposes of measuring workshare-related costs avoided within First-Class Mail Automation Letter is necessary. Accurate reporting of cost avoidance and passthrough calculations is essential to ensure compliance with the limitation on workshare discounts under section 3622(e)(2) of the PAEA.⁵

Additionally, Pitney Bowes has previously explained that the method used by the Postal Service to make modeled costs for Presort Letters for consistency with Cost and Revenue Analysis (CRA) costs can be improved.⁶ The adoption of a more accurate CRA adjustment would increase workshare cost avoidances substantially, further reducing the stated passthroughs in First-Class Mail Automation Letters.⁷

⁴ This calculation, consistent with the impact calculations presented by Pitney Bowes in Docket No. RM2012-6, assumes that AADC Automation Letter volumes comprise half of total AADC and 3-Digit Automation Letter volumes. *See* Dkt. No. RM2012-6, Comments of Pitney Bowes Inc. (December 7, 2012) at 10.

⁵ *See* Pub. L. No. 109-435, 120 Stat. 3198 (Dec. 20, 2006). The PAEA amends various sections of title 39 of the United States Code. Unless otherwise noted, section references in these comments are to sections of title 39.

⁶ *See e.g.*, Dkt. No. ACR2011, Comments of Pitney Bowes Inc. (Feb. 3, 2012) at 10; Dkt. No. RM2010-13, Comments of Pitney Bowes Inc. (Feb. 18, 2011) at 4-6.

⁷ Pitney Bowes recognizes that the statutory time limits imposed under section 3653 do not allow for the full consideration of a proposed change to the method currently used by the Postal Service to adjust modeled costs for Presort Letters for consistency with CRA costs. Consistent with data analysis for the previous six years in First-Class Mail and Standard Mail, a preliminary analysis confirms that the ratio of CRA-to-modeled costs remains substantially higher for non-incoming secondary (non-IS) costs than for incoming secondary (IS) costs, suggesting

C. First-Class Flats Cost Modeling Improvements

The FY2012 ACR identifies the passthroughs of the First-Class Mail Area Distribution Center (AADC) and 5-Digit Automation Flat discounts as being well in excess of 100 percent – 158.7 and 131.5 percent, respectively. *See* FY 2012 Annual Compliance Report at 12. These passthroughs are based on inaccurate cost avoidance estimates. Under the Postal Service’s proposed changes to the flats cost avoidance model, *see* Docket No. RM2012-8, these passthroughs are much closer to 100 percent. *See* USPS-FY12-3, FY12.3 Alternate Worksharing Discount Table_Final.xls, “FCM Flats.” To ensure that any compliance assessment is based upon the best available information, Pitney Bowes encourages the Commission to use the improved RM2012-8 flats cost model, which USPS-FY12-11 updates to FY 2012, in making its compliance determination.

Additionally, as detailed in comments filed in Docket No. RM2011-3, *see* Comments of Pitney Bowes Inc. (Feb. 18, 2011) at 2-3, the CRA appears to overstate the cost of First-Class Mail Presort Flats, thereby understating the cost difference between Single-Piece and Presort Flats. Pitney Bowes urges the Postal Service to review the accuracy of First-Class Mail Presort Flats cost data and propose improved costing methods for use in future Annual Compliance Reports.

that a uniform CRA adjustment factor continues to be inaccurate. Pitney Bowes is considering whether to file a separate petition to initiate a rulemaking to assess a potential change in analytic principle.

D. Future Proceedings

1. Workshare / pricing policies

Last year the Postal Service justified certain price adjustments that discouraged worksharing within First-Class Presort Letters on the basis of “excess capacity.” *See* Docket No. R2012-3, Notice of Market Dominant Price Adjustment (Oct. 18, 2011) at 35. Numerous parties filed comments raising concerns regarding the legal and policy implications of the Postal Service’s shift toward an exclusionary and inefficient pricing policy. *See* Dkt. No. ACR2011 PR Comments at 10, NAPM Comments at 2-3; NPPC Comments at 6, Joint Comments of DMA, MFSA, MMA, NPPC, and PSA at 3, PB Comments at 2. The comments also appealed to the Commission to exercise its authority to address these issues:

The above-captioned parties urge the Commission to address this issue in its forthcoming Annual Compliance Determination. In the most recent price adjustment, the issue affected First-Class Mail worksharing. In the price adjustment the year before the Postal Service pursued a similar approach with respect to Standard Mail machinable parcels. This is a disturbing trend. A shift in prices to discourage worksharing and increase work performed by the Postal Service, could befall virtually all mail classes, products and rate categories.

That the Postal Service would attempt to capture more work by reducing workshare discounts in the face of volume declines is predictable, even if it is self-defeating. *See* Comments of the Direct Marketing Association (Feb. 3, 2012) at 3-4 (demonstrating that the Postal Service could maximize the contribution from First-Class Mail by lowering prices on Presort Letters). But the predictability of this shift underscores the importance of the Commission’s role in ensuring that pricing signals enhance efficiency.

The effects on productive efficiency generally and on postal operations specifically are only one dimension of this issue. Setting discounts at less than costs avoided raises serious competition policy concerns because doing so is inherently exclusionary. *See* Comments of John Panzar (Feb. 3, 2012) at 5. Under the PAEA, it is the Commission’s responsibility to prevent exclusionary pricing and to ensure that postal pricing policies promote economic efficiency and the long-term sustainability of the postal system. *See id.* at 14.

We ask the Commission, in this proceeding, to instruct the Postal Service to construct price signals that recognize the importance of efficiency by promoting worksharing, as opposed to making use of excess capacity. This is necessary to

create a more equitable, nonexclusionary price schedule that fully reflects the value of worksharing.

Joint Comments at 2-3.

In the last annual compliance proceeding, Dr. John Panzar filed comments explaining that a central tenet of modern rate regulation in other network industries in the United States and around the world is the prohibition of exclusionary pricing in upstream competitive markets. *See* Docket No. ACR2011, Comments of Dr. John Panzar (Feb. 3, 2012) at 4-5. Dr. Panzar's comments explain that a shift in the Postal Service's pricing policy that results in setting discounts at less than costs avoided for any reason is exclusionary and should be prohibited by the Commission under its authority under section 3622(a) of the PAEA:

Worksharing discounts less than avoided costs are exclusionary. They prevent equally efficient competitors from participating in the market for upstream mail processing. For this reason, an ECP based access pricing ceiling (worksharing discount floor) should be a part of any modern system for regulating rates. In the context of the PAEA, this would require adherence to the avoided cost standard for all worksharing discounts. This somewhat unusual situation results from the atypical PAEA requirement that ECP also be used to determine an access pricing floor.

Thus the current Global Price Cap system used to regulate the rates of Postal Service market dominant products does not meet the PAEA standard. Fortunately, under Section 3622(a), the Commission has the authority to create a modern system for regulating rates by adding the ECP requirement.

Panzar Comments at 5.

In its decision in Docket No. ACR2011, the Commission observed that such matters were beyond the scope of its annual compliance determination and would, if appropriate, need to be addressed in separate rulemaking proceeding. *See* Docket No. ACR2011, Annual Compliance Determination Report (Mar. 28, 2012), at 102. Accordingly, Pitney Bowes urges the Commission to initiate a separate rulemaking on this important issue as soon as possible following the conclusion of the annual compliance review.

2. Compilation of Commission-approved methodologies and models

As part of its Annual Compliance Report, the Postal Service requested that the Commission file “alongside its FY 2012 ACD, all of the models that the Commission has applied in preparing the ACD, so that the Postal Service can ascertain that it has the most up-to-date models when it prepares the FY 2013 ACR.” USPS ACR at 6. Pitney Bowes supports this initiative to create a publicly accessible library of up-to-date cost models. Ensuring the availability of up-to-date models will promote the PAEA’s goals of enhanced transparency and accountability and ensure that pricing decisions are made and evaluated based upon the most recent and accurate cost data.

III. CONCLUSION

For the reasons discussed above, Pitney Bowes respectfully submits that: (1) the Postal Service should rebalance the unit contribution of First-Class Mail letter products to create a more equitable price schedule and improve its financial position, (2) the Commission should adopt changes to the First-Class Automation Letters cost models to ensure accurate measurement of workshare-related costs avoided, (3) the Commission should adopt improvements to the First-Class Mail Flats costs models, (4) the Commission should initiate a separate rulemaking to consider strengthening its workshare regulations to promote efficiency and prevent against exclusionary pricing, and (5) the Commission should implement the Postal Service’s proposal to create an up-to-date compilation of current approved methodologies and models.

Pitney Bowes appreciates the Commission's consideration of these comments.

Respectfully submitted:

/s/

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